COMMENTS ON THE MORTGAGE AND SALE MARKETS

FOR COMMERCIAL REAL ESTATE

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My name is Mark Elliott, and I am a partner in the real estate group of Troutman Sanders LLP, and head of our Office and Industrial Real Estate Group nationwide. I have practiced real estate law in Atlanta for nearly 30 years, with a focus on the commercial office sector.

Let me start by saying that Atlanta is a real-estate town; we love our sparkling, tall, new buildings. There is an enormous amount of distress in the commercial loan markets in Atlanta; certainly more than I have witnessed in my 30 years of practice. The distress arises out of the nearly complete shut down of new loans into the market, and a corresponding and nearly as dramatic shut down of the replacement of existing loans on commercial properties in the market. This shut down of the finance side has had an equally dramatic effect on the buy-sell side of commercial real estate assets; without the means to finance an acquisition, almost nothing is being bought or sold, and assets that would normally, in due course, have been moved from less productive to more productive owners, are staying in the hands of those who would wish them gone.

Some numbers, for context and to better illustrate how far this market has fallen, would be in order here. Deal volume for transactions (purchases and sales) by dollars on a national basis (for commercial real estate asset sales), when comparing calendar years 2009 to 2007, ran at roughly 6%. Stated another way, deal volume was for 2009 1/16th of what it was in 2007. We as a country reacted with dismay when over-all retail sales dropped, on a year to year basis, by roughly 7%. In the commercial transaction market, we are talking about having experienced a 94% drop in sales volume; for those who rely on real estate sales for their profession, it is a catastrophe.

I think the root causes of this shut-down in the finance and sale markets for commercial office buildings, on a fundamental level, are 2 fold; there is a problem on the demand side with borrowers and owners and there is a problem on the supply side, with lenders and banks. I will break down the components of the problems on the demand side and on the supply side, as each has several reasons.

<u>Demand Side:</u>

On the demand side, very few commercial property owners currently desire to take on new debt obligations, and commercial Lenders continue to report upon and express frustration at poor revenues arising from "weak borrower demand". This reluctance by borrowers would exist even if there was cash being dropped from helicopters, if picking up that cash today meant that it would have to be paid back, eventually. This reluctance to take on additional debt arises for 3 specific reasons.

(i) The tremendous loss of jobs evidenced by our current unemployment rate of 10.2% has completely undercut the need for office space. Quite simply, we have lost 6.1 million jobs since the beginning of 2009, and each one of those lost jobs represents an unoccupied office, somewhere. Here in the State of Georgia, we are suffering the highest unemployment rate in the history of the state. That translates into empty offices and office buildings here in Atlanta.

(ii) The loss of confidence by the leadership in the business sector, coupled with the losses in market capitalizations, has undercut the willingness of companies to take on obligations for space needs that they do not know they can fill, especially as they sit on an inventory of empty office space brought on by their staff reductions over the last year. Long-term planning would normally include projecting business growth, leading to hiring growth, leading to increased space needs. Capitalism has always carried with it a sense of optimism, but that optimism is difficult to find in the business community, today. The long-term planning that we see now for our business leaders does not include projecting business growth.

(iii) The mandates to cut costs in corporate America in all conceivable ways has led financial officers to focus on one of their higher costs; their real estate. Cutting real estate costs by reducing space needs has been an easy and dramatic way to react to profit pressures imposed by eroding sales. Reducing space costs can come from 2 distinct directions: leasing less space, and demanding lower payment obligations for the space that is leased, and both are achievable in the current market. Each of those actions has a dramatic and negative effect on commercial building values.

Supply Side:

On the supply side, the banks have been very reluctant to lend money secured by commercial office buildings, for several reasons, and very difficult in renewing existing debt. Those reasons are as follows, and center into 4 primary categories:

(i) More stringent underwriting standards by the banks, arising out of the (quite appropriate) caution from the lessons learned by this recent real estate crash, have caused banks to create a financing box that very few owner and developers of real estate can fit into. For example, a building with a $100,000,000.00 value in 2006 might very well attract financing with an 80% loan to value 1st priority loan (of $80,000,000.00) and a 10-15% loan to value subordinate, or mezzanine loan, leaving the owner to come up with 5 to 10 million dollars in equity. That same building today, with the same tenant mix, might be valued at $70,000,000.00; and might attract a first priority loan with a 60% loan to value ratio (or a $42,000,000.00 loan). That means in a 3 year period the amount of first priority debt that the same commercial office building could support and obtain has roughly been cut in half, of what it once was.

(ii) The tenant base in buildings, which owners and lenders rely upon to pay their agreed upon rents to service the debt and pay expenses, has undergone a dramatic change in credit-worthiness and stability, reflecting the general upheaval of corporate credit ratings throughout the country. The recent run-ups in the stock market have mitigated this problem to some extent, but the underlying unease remains. That unease manifests itself in 2 primary ways: how can this tenant with a much lower market capitalization and diminished credit rating continue to pay rents established and agreed upon when there was a much more vibrant and rich real estate market, and how willing will the tenant be to continue to pay full rent on all of its leased space, when, because of cutbacks, that company only occupies 70% of the space that it occupied 2 years ago, and the "market rate" for that rent, were it adjusted today, would be 20% less than the coupon rate? The effect of this unease is a discount being taken off of projected income streams from buildings, further diminishing asset values, and further diminishing the amount of borrowing available for that owner and that building.

(iii) The regulatory environment which banks face has become increasingly more difficult, increasingly harsh and critical to their performance and increasingly more stringent. Banks' overall loan portfolios are being increasingly criticized, and because of this, to the extent credit is available from banks, it is available only to the best borrowers. Banks have become much more reluctant to make new loans, for fear of regulatory penalties. 2 years ago, a project that was 35% pre-leased (before the start of construction) could get financing, on the basis that the lease-up of the unleased space would continue in the ordinary course. That same loan, if made today, would draw harsh regulatory criticism as being too speculative. The regulatory pendulum has swung from being too forgiving and lax, to too stringent and unforgiving, and a comfortable median that allows more credit to flow needs to be found. Indeed, loan portfolios that 2 years ago passed muster are today drawing criticism from the regulatory authorities, even though nothing in the portfolio has changed, except the external market conditions.

2 months ago, guidance was given at the federal level to the regulatory authorities, suggesting less stringent treatment and more lee-way provided for certain existing loans and loan portfolios, that attempted to address some of these concerns. However, the guidance given is still open to interpretation and, in this environment, that interpretation will trend toward the cautious, and this guidance did not address at all the views on or relief for new lending, which views remain very critical, and not favorable at all.

(iv) Perhaps appropriately, there is virtually no new commercial real estate development under way and thus, no commercial real estate development loans being made. Because of too much speculative development and the diminished economy, there is a fundamental over-supply of real estate in every product class and of every type. While some of this imbalance might be addressed with functional obsolescence of certain real estate, we would be well served if very few new shovels go in the ground for commercial real estate in calendar year 2010.

I next want to address the commercial mortgage backed securities market, and why there is such substantial dysfunction in that market. The CMBS market, at its peak in calendar year 2007, contributed nearly sixteen billion dollars of debt capital for the commercial real estate market. Because of the terrible troubles associated with the securities sold with this market, that market is essentially gone right now; it would be extraordinarily difficult today to find buyers for these sorts of securities. No funding sources exist or have arisen that could come close to replacing that CMBS market.

But the problems with the CMBS market go much further than the fact that the market for new CMBS loans has disappeared; we still have what was already done with CMBS loans in that market. The complexity and tortured structures that developed around this business worked very well when it came to slicing up and selling the various level and tranches of debt. The structures have not worked well at all in the environment we now find ourselves in; plunging real estate values that have put the real estate assets value at less than the entire debt, and somewhere in the middle, but probably near the top, of the various debt interests. Where do you go with $100 million of debt which is into 6 levels, when the underlying asset is only worth $70 million, today? Who has the power to sort through and resolve potentially conflicting interests?

What has made this very vexing is how control for negotiating the debt instruments and the debt itself has been allocated, under the service agreements which dictate the identity, selection and role of the servicers of the debt, who are responsible for "dealing with" the loan and the troubled borrowers. Very typically, the holder of the most junior (last in line for payment) debt piece in the sliced up debt stack gets to select the loan servicer. That level of debt is the least likely to make some principal accommodation to a troubled borrower, on a troubled asset, because the first dollars written off in a debt reduction scenario come 100% from the most junior loan piece.

Functionally, all the holder of the most junior loan piece in a CMBS structure wants is time; time that will allow the poorly valued asset to increase in value, because of economic recovery (jobs); generally higher real estate values, across the board (inflation) or some other, unforeseen cause and rescue. A resolution (such as a foreclosure or a deed in lieu to the most senior debt piece) today wipes out the junior holder's piece of the debt. Because of that desire for time, stalling and deferring is the preferred course of action.

However, that very action of deferral causes 2 distinct problems. First, it is contrary to the desires of the more senior debt, who could get paid 100 cents on the dollar for their portion, even if the debt as a whole is not paid in full. The senior debt could then turn around and re-lend the borrowed proceeds (somewhere, maybe), to a more promising project.

Second, for the troubled real estate asset and the real estate community, waiting is not necessarily the best answer on a macro-economic sense. The best answer for the troubled asset might very well be to move it into more productive or creative hands, to find a better or even a different use. That movement will not happen, under the current conditions and circumstances, and with current lock-up of the CMBS Market.

There have been efforts to invigorate and provide capital and liquidity for the private mortgage and securitization market through government interaction and help. So far, while those efforts have been thoughtful and sincere in their intent, they have not produced anywhere near their desired effect.

On March 23, 2009, the Treasury Department, the Federal Reserve, and the FDIC announced details of a Public-Private Investment Program designed to (i) remove toxic real estate loans and securities from the balance sheets of U.S. depositary institutions, which include banks and thrifts (**Participant Banks**), (ii) rejuvenate real estate credit markets and (iii) restart the real estate loan securitization market. The Public-Private Investment Program was divided into two programs, (a) the Legacy Loans Program dealing with residential and commercial real estate loans held by Participant Banks and (b) the Legacy Securities Program dealing with commercial mortgage backed securities (**CMBS**) and residential mortgage backed securities (**RMBS**).

Legacy Loans Program

The initial announcement of the Legacy Loans Program gave a basic framework of how the program would work. The FDIC would oversee the program. Private investors were to invest equity equally with the Treasury to purchase portfolios of troubled whole loans. This equity was to be paired with purchase money debt (of up to a 6:1 debt to equity ratio) guaranteed by the FDIC to finance the loan purchases. The loan portfolios were to be purchased through an auction process conducted by a financial advisor authorized by the FDIC.

Following the initial announcement of details regarding the Legacy Loans Program, the FDIC held multiple conference calls in which industry participants (e.g. law firms, mortgage brokers, bankers) were invited to submit questions and deliver comments to help structure the Legacy Loans

Program. A public question and comment period closed on April 10, 2009, by which time industry participants were asked to submit written questions and comments regarding the structure of the program that are posted on the FDIC's website. Hundreds of comments and questions were delivered to the FDIC ranging from brief expressions of outrage from individuals over the use of taxpayer dollars to detailed memoranda from large financial institutions and law firms aimed at providing input on the structuring of the program. These comments and questions are available to the public at http://www.fdic.gov/llp/LLPcomments.html.

Following the close of the public comment period and the initial anticipation regarding the Legacy Loans Program there was a lull in discussion regarding the program. On May 28, 2009, a Wall Street Journal article reported that the Legacy Loans Program was stalling and may be put on permanent hold. On June 3, 2009, the FDIC acknowledged the issues with the Legacy Loans Program when it issued a press release announcing the postponement of "a previously planned pilot sale of assets." After these acknowledgements of the issues with the program, it is not unfair to say that the initial public fervor for the Legacy Loans Program waned significantly.

Since the summer of 2009, their have been intermittent announcements regarding the status of the Legacy Loans Program. On September 16, 2009 the FDIC issued a press release stating that the FDIC had signed a bid confirmation letter for a pilot sale of receivership assets that the FDIC was conducting to test the funding mechanism for the Legacy Loans Program. In November 2009 Sheila Bair, Chairman of the FDIC, commented that the FDIC was continuing to develop the Legacy Loans Program and showed optimism in hoping to launch to program in the first quarter of 2010.

The FDIC put a positive spin on the delay in launching the Legacy Loans Program by stating that the delays occurred because "banks have been able to raise capital without having to sell bad assets through the Legacy Loans Program, which reflects renewed investor confidence in our banking system." However, skeptics may attribute the delays to various other factors. The abundance of questions and comments presented during the public comment period showed that many complex structural questions needed to be addressed before the program could be implemented. Numerous concerns were also raised regarding private investors' ability to exploit the program or "game the system" for their benefit at the expense of taxpayer dollars. These concerns are all set forth at length in the questions and comments submitted during the FDIC's public comment period.

A key accounting rule change made by the Financial Accounting Standards Board (**FASB**) in April 2009 giving banks more leeway to estimate the value of the loans on their books should also be considered in its effect on the Legacy Loans Program. FASB suspended it fair-value, or mark-to-market accounting rule, that required banks to mark assets each quarter to reflect market prices. The fair-value accounting rule forced banks to show tremendous losses in the distressed mortgage market. Once this rule was suspended it permitted the banks to immediately reduce writedowns and boost net income, easing pressures on banks to unload troubled assets through the Legacy Loans Program.

Circumstances other than the questions regarding the structure of the program and the effect of the FASB accounting rule change may also have been involved in the slowdown of the Legacy Loans Program. Political pressures may have played a part in influencing the FDIC. Numerous commentators expressed outrage over the government's subsidy of banks' prior poor underwriting practices. One non-profit government investigatory group, Project on Government Oversight (POGO), even questioned whether the FDIC was overstepping its authority and placing billions of taxpayer dollars at risk without congressional approval.

The FDIC's much-augmented role in addressing other more immediate economic problems should not be underestimated in the part it also may have played in interfering with the implementation of the program. Handling its primary role of overseeing the nation's depositary institutions, the FDIC handled over 140 bank failures in 2009 alone. The resources that the FDIC had to dedicate to managing this unprecedented number of bank failures probably also contributed to taking the FDIC's focus away from moving the Legacy Loans Program forward.

While we may not be able to determine how much each of the aforementioned factors played in stalling the implementation of the Legacy Loans Program, what we do know is that this once has highly-publicized program lost a great deal of momentum and has been largely quiet since its unveiling last spring.

Legacy Securities Program

The other component of the Public-Private Investment Program, known as the Legacy Securities Program, has met with more success than the Legacy Loans Program. In the Legacy Securities Program private sector fund managers and private investors partner with the Treasury to form Public-Private Investment Funds, or PPIF's, that purchase eligible securities backed directly by mortgages that span the residential credit spectrum (e.g., prime, Alt-A, subprime mortgages) as well as the commercial mortgage market from eligible sellers such as banks, insurance companies, mutual funds and pension funds. The equity capital raised from private investors by the fund managers is matched by Treasury. Treasury also provides debt financing up to 100% of the total equity of each PPIF. Furthermore, Treasury allows the PPIFs to obtain additional financing, up to certain limits, including from the Federal Reserve´s Term Asset-Backed Securities Loan Facility (**TALF**) program for those assets that are eligible for TALF financing (currently restricted to CMBS only).

On July 8, 2009 Treasury selected the following nine fund managers to manage the PPIF's and to commence raising equity capital from private sector investors to purchase legacy securities: AllianceBernstein, LP, Angelo, Gordon & Co., LP and General Electric Capital Corporation Partnership, BlackRock, Invesco Ltd., Marathon Asset Management, LP, Oaktree Capital Management, LP, TCW Asset Management, Wellington Management Company, LLP, Western Asset Management Company. These fund managers were selected based on numerous criteria, namely (1) demonstrating capacity to raise at least $500 million of private capital,

(2) demonstrating experience and a track record in dealing with eligible CMBS and RMBS assets, (3) a minimum of $10 billion in eligible CMBS and RMBS assets under management, (4) demonstrating operational capacity to manage PPIF's in accordance with Treasury's objectives, and (5) having headquarters in the United States.

Since the selection of the nine fund managers, six rounds of initial closings have been conducted under the Legacy Securities Program. As of December 18, 2009, all nine fund managers had completed an initial closing, and the PPIF's had completed initial and subsequent closings on approximately $6.0 billion of private sector equity capital which has been matched 100 percent by Treasury, representing $12.0 billion of total equity capital. Treasury has also provided $12.0 billion of debt capital.

I thank you for your time and attention today, and I will be happy to answer any questions you have or clarify any points I have made.

Anthony Greene assisted me in the preparation of this presentation.